BDC
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economic LETTER

NOVEMBER 2014

FALLING OIL PRICES: CAUSES, AND CONSEQUENCES FOR CANADA

The price of crude oil has plummeted by 24% since last summer, from US$105 per barrel at the end of June to US$81 per barrel at the end of October[1]. This is mainly due to the expansion of global supply, combined with outlooks for weaker demand.

Two factors are responsible for the increase in oil supply: the resumption of exports from Libya, and higher output in the United States. Although the crisis that has been ravaging the country for several years has yet to be resolved, Libya has been able to re-open the export terminals that it was forced to close around a year ago. Libya's oil output, which stood at 1.5 million barrels per day in normal conditions, was no more than 200,000 barrels per day last May; since then, it has gradually climbed to nearly one million barrels per day. In the United States, production of oil extracted from rock–shale oil–has been rising steadily. According to some analysts, the United States will outstrip Saudi Arabia this year as the world's top oil producer[2]. At the same time, the European economy is faltering again, and China's growth outlook has been revised downwards, fuelling concerns of a decline in global demand for oil.

Apart from factors relating to supply and demand, which are generally referre to as "fundamentals", oil prices are influenced by investors' expectations. Accordingly, events that are likely to disrupt supply, like those we are currently observing in Syria and Ukraine, generally have the effect of driving prices up. It definitely seems that the fundamental factors currently outweigh the others, probably because the supply of oil has not really suffered, so far, from the conflicts that are raging in those countries.

Should we expect the price of oil to continue its downward trend, to stabilize, or to climb back up in the months ahead? Truth be told, it is practically impossible to predict. The price of oil, like the exchange rate of the Canadian dollar, which is closely tied to it, are the two economic variables that are the most difficult to predict. In July, just before prices started dropping, Consensus Economics, relying on data provided by 61 forecasters, was anticipating that, by the end of October, the price of a barrel of Brent would lie within a range of US$105 to US$116.30.[3] Well, on October 31, the price of Brent stood at US$86 per barrel!▼

1 This is the price of West Texas Intermediate, but the price of Brent declined by the same percentage during that period.
2 See http://www.bloomberg.com/news/2014-07-04/u-s-seen-as-biggest-oil-producer-after-overtaking-saudi.html
3 Consensus Economics Inc., July 14, 2014, page 27.

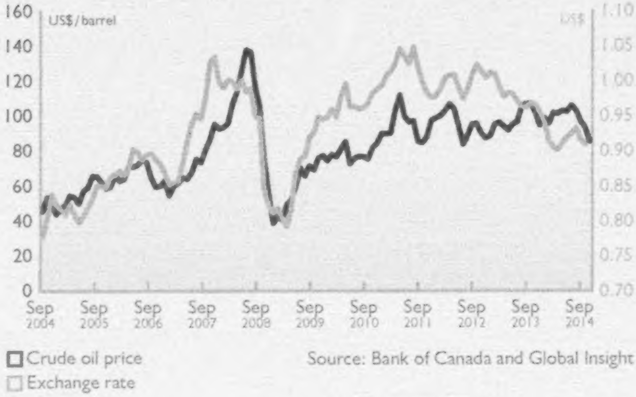
BDC's Monthly Economic Letter is prepared by the Economic Analysis team from Marketing and Public Affairs and is based on a variety of public sources of economic data. The information in this letter is drawn from data released prior to November 8. Reliance on and use of this information is the reader's responsibility.

Frequently, when the price of oil drops significantly, the Organization of the Petroleum Exporting Countries (OPEC) reacts by cutting production, so as to drive prices back up. The extraction costs faced by the OPEC member countries are considerably lower than those of the countries that produce unconventional oil. Consequently, their output would still be profitable even if prices were to fall below US$80 per barrel; this would not hold true for producers of unconventional oil. That said, the OPEC member countries need oil revenues to drive their economies, and a more pronounced drop in prices could prevent many of them from balancing their budgets. Consequently, the analysts believe it is very unlikely that prices will keep falling much longer.

Lower oil prices are not without consequences for the Canadian economy. In the short term, they have no real impact on the volume of oil producers' output, but it obviously causes their revenues, as well as the royalties paid to governments, to decline. In the medium term, if prices remain low or keep falling, investments in new oil projects could be put on hold. This would have repercussions, not only on the oil sector, but also on related industries.

The slump in oil prices also has positive economic effects. Lower prices for fuel and heating oil, caused by lower crude oil prices, enable households to increase their consumption of other goods or services. Furthermore, because Canada is a net exporter of oil, the decline in oil prices generally leads to depreciation of the Canadian dollar. As shown in the graph below, these two variables are very closely linked. Depreciation by the loonie would have a positive effect on many industries, as it would stimulate exports, in particular those of manufacturing companies.

Price of crude oil and Canada/United States exchange rate



Source: Bank of Canada and Global Insight

According to the Bank of Canada, the net effect that a decline in the price of oil would have on Canada is negative. For now, it appears to be limited. In fact, based on the assumption that the price of oil during the projection period will be equal to its recent average, the central bank has stated that "on net, the Bank estimates that the weaker profile for the terms of trade in this projection compared with July will curb GDP growth by approximately 1/4 of a percentage point in 2015"[4]. Due to data rounding, the downward revision is not visible at the end of the day: real GDP growth predicted by the Bank for 2015 is still 2.4%.

The price of oil is not only very difficult to predict, it is also very volatile. Sizable pullbacks like that which has just occurred can be followed by surges just as significant. Companies whose profit margins are very sensitive to fluctuations in oil prices are well advised to develop a strategy for coping with them, as is done by those that are vulnerable to fluctuations in the exchange rate.■

CANADA

Back

Real GDP data for July and August seem to point toward a slowdown in economic growth in the third quarter. On the other hand, the employment and international trade data for the month of September turned out very positive, suggesting that GDP growth in September could be strong, making up for the weakness of the first two months of the quarter.

GDP pulls back slightly

Real GDP slipped by 0.1% in August, after remaining static in July. Output contracted by 1.0% in the goods sector, accounting for 30% of GDP, while it expanded by 0.2% in the service sector. The largest pullbacks were recorded in the oil and gas extraction sector, which was affected by maintenance activities, and in manufacturing, which posted a decline after three straight monthly increases. The data for July and August point toward slower growth in the third quarter. Assuming that real GDP stays flat in September, third-quarter growth will come in at an annual rate of 1.4%—just half that of 3.1%, which was recorded in the second quarter.

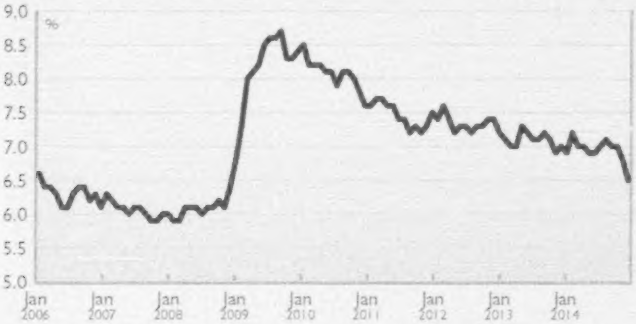
Employment posts a substantial gain

Employment expanded by 43,000 jobs in October. The gain breaks down into 26,500 full-time jobs and 16,500 part-time jobs. The unemployment rate dipped 0.3 percentage points, reaching 6.5%, its lowest point in six years (graph). Since July, employment has grown by an average of 37,000 jobs per month while, during the first half of the year, the average▼

4 Bank of Canada, Monetary Policy Report, October 2014, page 24.

monthly gains were slightly below 9,000. Thus, the labour market has seen definite improvement in recent months. That said, since June, the gains have been more substantial—all things considered—in part-time work (2.1% between June and October) than in full-time work (0.5%).

Unemployment rate
(January 2006 to October 2014)

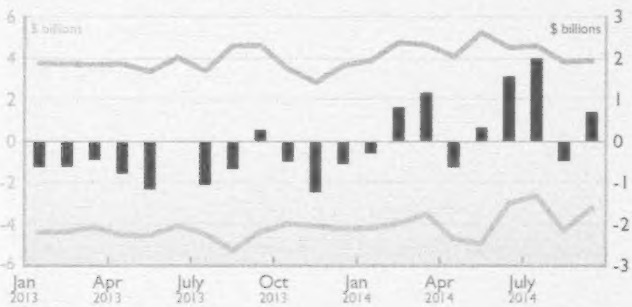


Source: Statistics Canada

The trade balance swings over from a deficit to a surplus

Canada's trade balance swung from a deficit of $463 million in August to a surplus of $710 million in September, thanks to a combination of two factors: a drop (-1.5%) in imports and an increase (1.1%) in exports. The trade surplus with the United States held steady, while the deficit with other countries narrowed (graph). The decline in imports is mainly attributable to the pullback in imports of crude oil—partly linked to the fact that certain Canadian refineries cut back their operations to carry out maintenance work—and to the decrease in imports of metal and non-metallic mineral products, which had recorded a sharp spike in the previous month. As for the increase in exports, it was widespread, since 8 of the 11 major sectors reported increases. The largest of these were observed in the following sectors: automotive vehicles and parts, consumer goods, and metal and non-metallic mineral products. For both imports and exports, the variations are mainly due to changes in volumes, which is good news. Indeed, it means that net exports of goods should make a positive contribution to real GDP in the third quarter.

Trade balance
(January 2013 to September 2014)



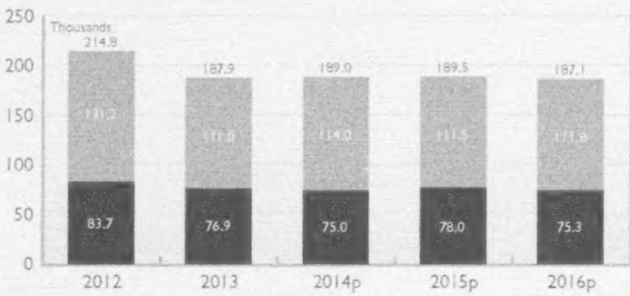
Total (right)
United States (left)
Other countries (left)

Source: Statistics Canada

Housing starts should remain stable in 2015

The Canada Mortgage and Housing Corporation (CMHC) has revised its forecast of housing start numbers for 2014, upwards, from 184,800 to 189,000 units. It anticipates that housing starts will remain stable in 2015 (189,500 units) and decline slightly in 2016 (187,100 units) (graph). The CMHC expects that economic conditions will improve in the short term, but that their positive effect on homebuilding will be limited by certain factors, including the high number of homes completed but not yet sold in the multiple-dwellings segment. In the longer term, housing starts will feel the impact of slower growth in the population between the ages of 25 and 34, shinking the pool of first-time buyers. ■

Housing starts (number of units, 2012 to 2016)



Multiple
Single

Source: Canada Mortgage and Housing Corporation

★ UNITED STATES

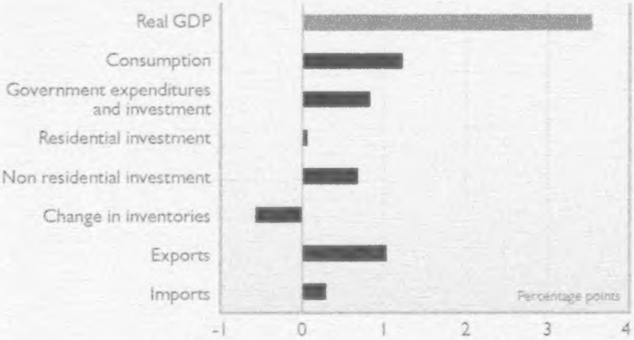
Back

Solid third-quarter real GDP growth, a strong surge in employment along with a significant drop in the unemployment rate and improvement in the housing market: all indicators are now showing that economic growth in the United States is firming up.

GDP growth remains strong

Real GDP grew by 3.5% in the third quarter after increasing by 3.3%, on average, during the two previous quarters (annual rates). Consumption, net exports, non-residential investment and government spending and investment all made significant contributions to real GDP growth. On the other hand, the contribution from residential investment was small, and that of change in inventory came out negative (graph). If real GDP keeps growing at the same pace in the fourth quarter, the annual growth for 2014 will reach 2.3%, which is close to the figure established by Consensus Economics (2.2%), based on the average of 31 forecasts.

Contribution to percent change in real GDP, third quarter of 2014

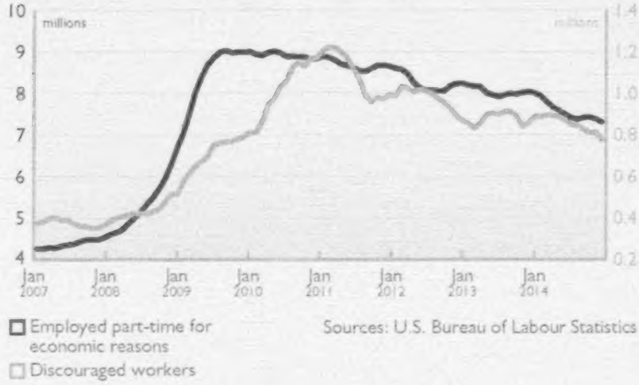


Source: U.S. Bureau of Economic Analysis

Employment keeps rising

Non-farm employment climbed by 214,000 jobs in October and the unemployment rate fell by 0.1 percentage points to reach 5.8%. Taking into account the upward revisions to the employment data of the two previous months, the average monthly change has been 229,000 so far in 2014, compared with 194,000 in 2013. The number of discouraged workers (who have stopped looking for work because they are convinced they will not find any) and the number of persons working part time for economic reasons (because they cannot find full-time work or because their employer has reduced their work hours) is continuing to decline (graph). In short, the job market situation is continuing to improve.

Discouraged workers and persons working part-time for economic reasons (January 2007 to October 2014)

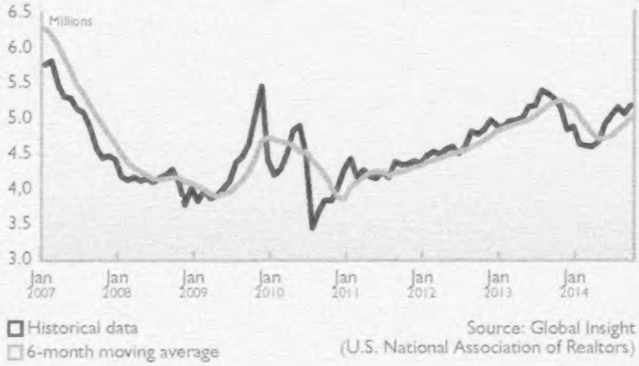


Sources: U.S. Bureau of Labour Statistics

Housing starts and sales of existing homes head up

Housing starts advanced by 6.3% in September. They rose by 1.1% in the single-family homes segment and by 18.5% in the multiple-dwellings segment. Year over year, housing starts were up by 17.8% in September. Sales of existing homes, which dipped slightly in August, picked up again in September, rising at a steady pace of 2.4% to reach 5.17 million units (graph). Despite that month-over-month increase, home sales are still 1.7% lower than they were in September 2013. However, the average price of all homes on the market is 5.6% higher than it was at this time last year. ■

Sales of existing homes
(January 2007 to September 2014)



Source: Global Insight
(U.S. National Association of Realtors)

INTEREST RATES

Back

No key interest rate hike in sight for months to come

On October 22, the Bank of Canada left the key interest rate unchanged at 1.0%, as anticipated, and issued its Monetary Policy Report containing its most recent economic projections. The central bank is still predicting acceleration in global economic growth, but at a slightly slower pace than in July. That said, its forecasts for the Canadian economy have barely changed. Real GDP growth should accelerate slightly but remain moderate over the next two years (table). The Bank predicts that the economy will not get back to running at full throttle until the second half of 2016, suggesting that the key interest rate will not be raised for several months to come.■

Bank of Canada projections

	2014	2015	2016
Real GDP	2.3%	2.4%	2.3%

Source: Bank of Canada, Monetary Policy Report, October 2014, page 24.

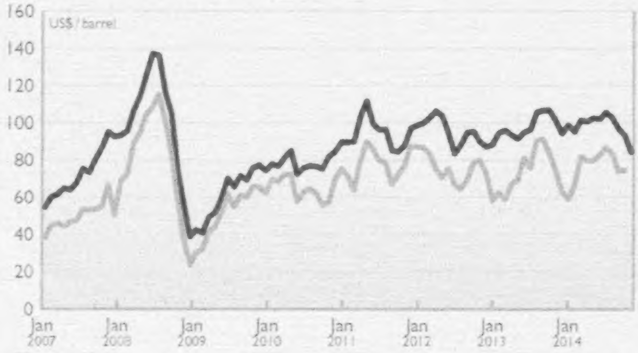
OIL PRICE

Back

The price of crude oil declines further

The price of crude oil, measured by the price of West Texas Intermediate, headed down in October for the fourth straight month. Compared with June, the drop is slightly more than 20%. This decline is due to expanding global supply, combined with weaker demand outlooks (see our lead story, pages 1 and 2, for more detailed analysis).■

Price of crude oil
(January 2007 to October 2014)



Source: Global Insight et Alberta Office of Statistics and Information

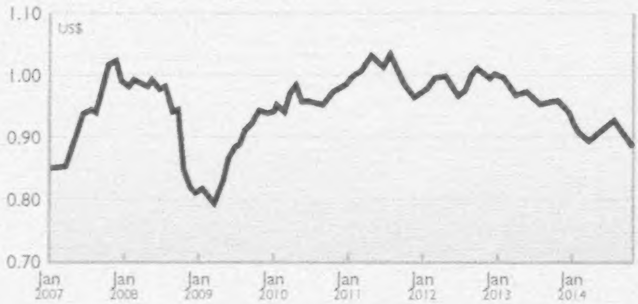
CANADIAN DOLLAR

Back

The loonie depreciates further

Between September and October, the loonie depreciated by 1.8% against the U.S. currency. The strong real GDP numbers south of the border in the third quarter bolstered expectations of a tightening of the Federal Reserve's monetary policy in the near future. Meanwhile, in Canada, real GDP data for July and August point toward slowing growth in the third quarter, and comments by the Bank of Canada, which expects that the Canadian economy will not get back to full potential until the second half of 2016, lead us to think that monetary policy will remain in expansion mode for a good while longer. The divergence between the two countries' monetary policies is helping to put downward pressure on the Canadian dollar. That pressure is exacerbated by the decline in the price of crude oil, of which Canada is a net exporter.■

Canada/United States exchange rate
(January 2007 to September 2014)



Source: Bank du Canada

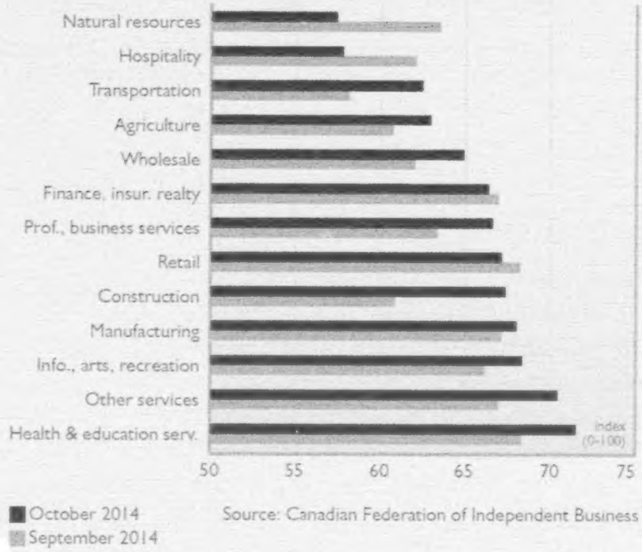
SME CONFIDENCE

Back

The confidence of SME owners improves

The Business Barometer Index compiled by the Canadian Federation of Independent Business rose by 2.2 points in October, reaching 67.8. This upswing is widespread: only 4 out of 13 sectors reported pullbacks, the largest being that of natural resources (graph). This is now the sector where SME owners' confidence is lowest; no doubt this is linked to the significant slump in the price of crude oil in recent months, something that could jeopardize future investment projects in the oil sector. But every cloud has a silver lining: we note definite improvement in confidence in the transportation sector, which will stand to benefit considerably from lower oil prices. ■

Business Barometer, by sector



Source: Canadian Federation of Independent Business

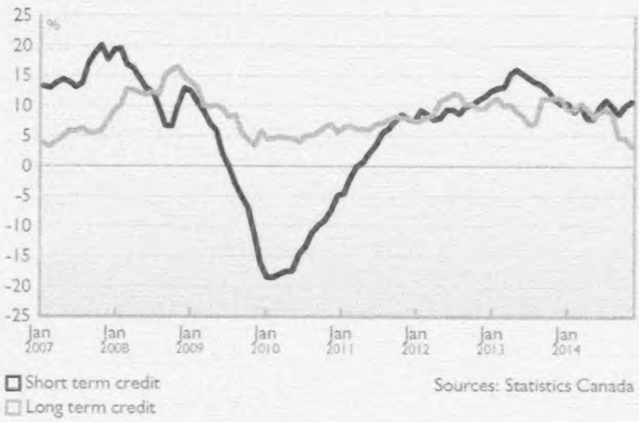
BUSINESS CREDIT CONDITIONS

Back

Short-term bank credit increases

The amount of credit granted to businesses by the chartered banks rose by 0.6% in September, after a 1.5% gain in the previous month. The September increase is entirely attributable to short-term credit (88% of the total), which expanded by 0.7% during the month, while long-term credit shrank by 0.5%. Year over year, short-term bank credit granted to businesses was up by 10.7% in September, and long-term bank credit by 3.4% (graph). ■

Business credit from chartered banks
(annual change, January 2007 to September 2014)



Sources: Statistics Canada

KEY INDICATORS—CANADA

Key indicators—Canada

	Historical[1]				2014[2]				Latest[3]		Forecast	
	2010	2011	2012	2013	Q1	Q2	Q3	Q4			2014	2015
Real GDP (% growth)	3.4	3.0	1.9	2.0	1.0	3.6			Aug	-0.1	2.3	2.5
Machinery and Equipment Expenditures (% growth)	10.6	8.1	1.9	-1.7	-6.3	4.2					-0.8	4.4
Pre-Tax Corporate Profits (% growth)	61.6	23.3	-6.7	0.7	47.3	0.7					9.8	5.2
Industrial Production (% growth)	6.0	3.9	0.9	1.9	4.5	4.4			Aug	-1.0	3.8	2.5
Industrial Product Prices (% growth)	1.5	6.9	1.1	0.4	12.7	0.6	-1.5		Sep	-0.5	2.5	1.6
Non-Residential Construction (% growth)	17.3	15.9	13.5	5.0	-0.5	0.6						
Housing Starts (' 000 units)	192	194	215	188	175	197	199		Sep	197	190	184
Personal Expenditures (% growth)	3.5	2.2	1.9	2.5	1.3	3.7					2.5	2.3
Consumer Price (% growth)	1.8	2.9	1.5	1.0	2.8	3.7	0.3		Sep	0.1	2.0	1.9
Employment (% growth)	1.4	1.5	1.2	1.3	0.4	0.3	1.4		Oct	0.2		
Unemployment Rate (%)	8.0	7.4	7.3	7.1	7.0	7.0	6.9		Oct	6.5	7.0	6.7
SMEs Confidence Index (CFIB)	66.7	66.4	63.9	63.9	64.2	65.4	64.7		Oct	67.8		
Manufacturers Confidence Index (CFIB)	68.5	67.3	66.7	63.8	64.9	64.6	69.0		Oct	68.1		

1. Annual growth rate
2. Quarterly growth, at annual rate
3. Month-over-month growth

Sources: Statistics Canada, Consensus Economics and Canadian Federation of Independent Business.